

The Effect of Corporate Governance Practices on Firm Performance: Evidence from Pakistan

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Abstract

Purpose – The purpose of this study is to investigate the effect of corporate governance practices such as (board size, board composition, CEO duality and audit committee) on the performance of selected Pakistani firms.

Research design, data, and methodology – This study examines corporate governance structure by using the data of 80 non-financial firms listed on Karachi Stock Exchange Pakistan during 2010-2014. Hypotheses of the study were tested by using both descriptive and inferential statistics.

Result – The findings indicate that board size and audit committee is positively related to the firm performance (ROA & ROE). In contrast, board composition and CEO duality are negatively related to the firm performance (ROA & ROE). As far as controlling variables is concerned, leverage is negative, whereas firm size is positively related to all measures of performance.

Conclusions – Empirical findings concluded that corporate governance practices affect the firm performance. Therefore, it is suggested that managers should understand the governance mechanisms to work more efficiently in the firm.

Keywords: Corporate Governance Practices, Firm Performance (ROA & ROE), Pakistani Firms.

JEL Classifications: G32, G34, L22, L25.

1. Introduction

Corporate governance is considered an important implication for the development of a country, because proper corporate governance practices attract investment capital, minimize the risk

for investors and increase firm performance (Spanos, 2005). The growth of corporate governance has been determined by renovating investor assurance in capital markets. In general, corporate governance is a structure by which firms are directed and controlled. Particularly, corporate governance treats with such behaviors in which financial suppliers confirm themselves of receiving a return on their investment (Shleifer & Vishny, 1997). The international financial crisis has resistant the significance of good corporate governance practices and structures. Moreover, currently it is well known that corporate governance practices play a significant role in improving firm performance and long term sustainability (Erickson et al., 2005; Iwasaki, 2008; Cho & Kim, 2007). Similarly, Saporovna and Sayatovna (2015) also argued that a properly structured system of corporate governance recognize more benefits in i.e. improving the efficiency of the firm, facilitating access to capital markets, the ability to attract financing on more favorable terms and strengthening the company's reputation.

Cadbury (1992) defined corporate governance as the system by which companies are directed and controlled. Pass (2004) argued that corporate governance is concerned with the duties and responsibilities of a firm board of directors to effectively handle the firm and their association with its shareholders and other stake holders.

1.1. Objectives of the Study

This study is designed to achieve the following objectives;

- To recognize the nature of relationship between corporate governance practices and firm performance.
- To investigate the effect of corporate governance practices on firm performance.

2. Literature Review

Corporate governance in the developing market has an important role in affecting the value of a firm. Although based on literature review there is an abundance of research which intends to explain the relationship between corporate governance

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and firm performance, empirical finding yields contradictory and inconsistent results. Empirical results and arguments have gone both ways. Some researchers reveal that there is positive relationship between corporate governance and firm performance, whereas others oppose by arguing that there is a negative effect on firm performance. A brief explanation of practices of corporate governance in relation to different theories of corporate governance and their effect on firm performance is presented below. These practices are indicated as board size, board composition, CEO duality and audit committee.

2.1. Board Size

Board size refers to the number of directors on the board. The board of directors manages and controls a firm and an effective board is essential to the success of a firm. Brennan (2006) argues that board of a firm is considered as one of the main internal corporate governance mechanisms.

There are two theories linked with the role of board size in affecting the company value. The first school of thought recommends that a bigger board creates value for shareholders as members of this board have a high level of experiences (Sah & Stiglitz, 1991). On the other hand the second theory recommends that a bigger board have many drawbacks, consisting of free riding and poor monitoring by all the members, wasting the company value (Jensen, 1993; Yermack, 1996).

Many studies (i.e. Pearce & Zahra, 1992; Dalton et al., 1999; Klein, 2002; Dwivedi & Jain, 2005; Coles et al., 2008; Ehikioya, 2009) found a positive relationship between board size and firm performance. While some researchers found a negative relationship of board size with the firm performance (i.e. Yermack, 1996; Eisenberg et al., 1998; De Andres et al., 2005; Ghosh, 2006; Boone et al., 2007; Cheng, 2008; O'Connell & Cramer, 2010; Kota & Tomar, 2010).

<Hypothesis 1> There is a significant relationship between board size and the firm performance.

2.2. Board Composition

Generally, the position of outside directors is linked with their capability to examine firm performance freely. Inside directors have more specific knowledge about company behaviors through their role as internal managers, whereas outside directors may give both expertise and independence in analyzing managerial decisions. From agency theory, outside directors are more essential in monitoring management because they are independence from managers of the firm (Fama & Jensen, 1983) and their expertise builds up from prior experience (Mace, 1986). Outside directors being financially free of management, independent from potentially contradictory conditions, capable to reduce agency problems and control managerial self interest (Rhodes et al., 2001).

Empirical studies related with the relationship between board composition and firm performance is mixed. Rosentein & Wyatt

(1990) revealed that the presence of outside directors leads to significant and positive share price reaction on firm performance. Similarly, Mashayekhi & Bazaz (2008) observed a positive relationship between outside directors on boards and firm performance. Moreover, Jackling & Johl (2009) also showed positive and significant relationship between outside directors on boards and firm performance. On the other hand, Agarwal & Knoeber (1996) found negative relationship between outside directors on boards and firm performance by using the data of 400 US firms. Coles (2001) found that more outside directors on boards have a negative effect on firm performance. Ehikioya (2009) also observed a negative relationship between outside directors and firm performance as measured by return on assets and price earnings ratio.

<Hypothesis 2> There is a significant relationship between board composition and the firm performance.

2.3. CEO duality

CEO duality is considered a statement when a company CEO also serves as the chairman of the board of directors. Agency theory argued that CEO duality decreases the monitoring effectiveness of a board over management. While, stewardship theory suggests that CEO duality could empower the CEO to promote a cohesive and strong leadership rather than deteriorating a board's independence from management and its monitoring role (Muth & Donaldson, 1998). In contrast, from an agency theory, comprising a separate and independent board chair reduces the CEO power and build up the board capability to implement its oversight role (Palmon & Wald, 2002; Kiel & Nicholson, 2003). Similarly, Fama & Jensen (1983) also argue that CEO and chairman should be separated, because a person holding both positions will dominate a board and can make a board ineffective in monitoring the managerial opportunity.

Empirical evidence on the relationship between CEO duality and firm performance brings ambiguous findings. For example, Abor & Biekpe (2007) noted a positive relationship between CEO duality and firm performance by using the data of SME's in Ghana. While, Ehikioya (2009) revealed a negative relationship between CEO duality and firm performance by recommending that both roles (i.e. decision management and decision control) should not be combined into a single position. On the other hand, Jackling & Johl (2009) establish no significant relationship between CEO duality and performance of top listed Indian firms. Similarly, Mashayekhi & Bazaz (2008) also found no significant relationship between CEO duality and performance of Iranian firms. Moreover, Elsayed (2007) also examined the data of Egyptian listed firms and indicate that board leadership structure does not directly affect firm performance.

<Hypothesis 3> There is a significant relationship between CEO duality and the firm performance.

2.4. Audit Committee

The audit committee is one of the company board committee containing of 3 to 5 and in some cases 7 non executive members and is responsible for overseeing all financial activities of the company (Salehi & Asgari, 2013). An independent audit committee fulfill a vital role in corporate governance (Engel, Hayes, & Wang, 2010). To have good corporate governance practices within a company, the audit committee must be effective in carrying out its duties. The composition and function of the committee can be use as observable feature that influence its effectiveness. Such features include, for example, the independence of the members of the audit committee and the chairperson of the board not being a member/chairperson of the audit committee (Balasubramanian et al., 2010; Chan & Li, 2008; Krishnan, 2005).

Prior research indicates the benefits of audit committees in terms of strengthening financial reporting quality (Davidson et al., 2005; Kent & Stewart, 2008; Rainsbury et al., 2008). While, Klein (2002) reports a negative correlation between earnings management and audit committee independence. Anderson et al., (2004) find that entirely independent audit committees have lower debt financing costs.

<Hypothesis 4> There is a significant relationship between audit committee and the firm performance.

<Table 1> Summary Table for Literature Review

The Effect of Corporate Governance Practices on Firm Performance			
1. Board Size and Firm Performance			
S#	Year	Authors Name	Empirical Results
1	1992	Pearce & Zahra	Positive
2	1996	Yermack	Negative
3	1998	Eisenberg et al.	Negative
4	1999	Dalton et al.	Positive
5	2002	Klein	Positive
6	2005	Dwivedi & Jain	Positive
7	2005	De Andres et al.	Negative
8	2006	Ghosh	Negative
9	2007	Boone et al.	Negative
10	2008	Coles et al.	Positive
11	2008	Cheng	Negative
12	2009	Ehikioya	Positive
13	2010	O'Connell & Cramer	Negative
14	2010	Kota & Tomar	Negative
2. Board Composition and Firm Performance			
15	1990	Rosentein & Wyatt	Positive
16	1996	Agarwal & Knoeber	Negative
17	2001	Coles	Negative
18	2008	Mashayekhi & Bazaz	Positive
19	2009	Jackling & Johl	Positive
20	2009	Ehikioya	Negative
3. CEO Duality and Firm Performance			
21	2007	Abor & Biekpe	Positive
22	2007	Elsayed	Not Significant
23	2008	Mashyekhi & Bazaz	Not Significant

24	2009	Ehikioya	Negative
25	2009	Jackling & Johl	Not Significant
4. Audit Committee and Firm Performance			
26	2002	Klein	Negative
27	2005	Davidson et al.	Positive
28	2008	Kent & Stewart	Positive
29	2008	Rainsbury et al.	Positive
30	2010	Engel, Hayes & Wang	Positive
31	2010	Balasubramanian et al.	Positive

3. Research Methodology

This study used secondary data approach with main focus to investigate the effect of corporate governance practices (board size, board composition, CEO duality and audit committee) on the performance of Pakistani firms. Muhammad et al., (2014) argued that secondary data are typically past data and do not need access to subjects or respondents because it is already assembled. Data relevant to corporate governance practices and performance measures were taken from the audited financial statement of the selected companies listed on the Karachi Stock Exchange (KSE) Pakistan during 2010-2014. A random sample of 100 companies was selected for data collection. After eliminating several companies for missing or incomplete data, the final sample set consist of 400 observations for 80 companies over a period of five year. The sample set include the firms from different industrial groups such as cement, textile, paper and board, engineering, chemical, sugar and allied, fuel and energy, and miscellaneous.

3.1. Dependent Variables

This study used firm performance is a dependent variable. There are various measures of firm performance, but in corporate governance studies accounting performance or market valuation are used. The company financial performance is considered a major standard to measure a firm financial and operational efficiency. The core of a company success is financial performance such as profit expansions, increasing profit on assets and also increasing shareholders values (Muhammad et al., 2014). Previous studies on corporate governance use either market based measures or accounting based measures to evaluate firm performance. Klein (1998) used return on assets (ROA) and Lo (2003) used return on equity (ROE) as an operating performance measure. Similarly, Brown & Caylor (2005) also used ROE and ROA as their two performance measures. This study measured the firm performance through ROA and ROE. ROA indicated the amount of earnings that have generated from invested capital assets, while ROE indicated that how much earnings a firm generates from the amount invested from its shareholders. ROA is computed through the net income divided by total assets, whereas ROE is equal to net income divided by shareholders equity.

3.2. Independent Variables

Corporate governance is used as independent variables. It used four dimensions of corporate governance practices such as board composition, board size, CEO duality and audit committee. Board size is measured as number of directors on the board. Further, board composition is measured as a dummy variable taking a proposition of outside directors setting on the board. Moreover, CEO duality is measured as a dummy variable taking a value of one if CEO is the chairman of the board, otherwise zero. Similarly, audit committee is measured as taking the value of one if there is audit committee exists in the board, otherwise zero. A "yes" response is given to a value of one and a "no" response is given to a value of zero.

3.3. Control Variables

Leverage and firm size is used as control variables. Leverage is measured as total debts divided by total assets. It includes leverage because debt may affect firm performance as it decrease the free cash flow (Jensen, 1986). In addition, highly leveraged firms are more strongly monitored by debt providers, who may put stress on the firms to take on good governance practices (Broberg, Tagesson & Collin, 2009). On the other hand, firm size is includes to capture the fundamental effects of performance and accountability within the independent samples of small and large firms. Firm size is measured as the natural log of total sales.

3.4. Data Transformation

Zikmund (1997) defined data transformation as the process of changing data's original form to a format that is more suitable to perform a data analysis that will achieve research objectives. Hence, the purpose of data transformation is to create a more suitable format for data analysis.

This study used ratios such as: ROA, ROE, Leverage, and Firm size. These ratios are not available in audited financial statement of listed companies. Hence, the process of deriving these ratios required a transformation of raw data into more suitable data for analysis. Computer package (Excel) was used to do this data transformation easily and quickly. The final retrieved data was entered in Statistical Package for Social Science (SPSS) for data analysis.

4. Results and Discussions

4.1. Descriptive Statistics

Table 2 shows descriptive statistics of dependent and explanatory variables, which reveal that average return on assets (ROA) and return on equity(ROE), is 18.22% and 19.84%

respectively. The average board size of the 80 firms used in this study is 9, whereas the proportion of outside directors sitting on the board is about 12.40 percent. The average of CEO duality shows that 80.5% of the samples firms have separate persons occupying the posts of the chief executive, while chairman of the board is merely about 19.5% of the firms have the same person occupying the two posts. In addition, the average of audit committees indicates that in 80% of the firms have audit committees. Moreover, leverage ratio shows that 40.2% of firm's total assets are financed with total debt. N represents the number of observations.

<Table 2> Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	400	-.04	.39	.1822	.11121
ROE	400	.06	.42	.1984	.08684
Board Size	400	7.00	10.00	8.5062	.90310
Board Composition	400	.00	.29	.1240	.08342
CEO duality	400	.00	1.00	.1945	.39632
Audit Committee	400	.00	1.00	.7905	.40744
Leverage	400	.18	.74	.4021	.15945
Firm Size	400	6.46	10.23	7.4611	.87866
Valid N (listwise)	400				

4.2. Correlation Analysis

Table 3 indicates the relationship between dependent variables and explanatory variables of the study. It shows positive relationship between firm performance (ROA & ROE) and board size having values of 0.229** and 0.190 respectively. Further, it indicates a negative relationship between firm performance (ROA & ROE) and board composition having values of -0.143** and -0.130 respectively. Moreover, there is a negative relationship between firm performance (ROA & ROE) and CEO duality having values of -0.219** and -0.186 respectively. It also shows a positive relationship between firm performance (ROA & ROE) and audit committee having values of 0.376** and 0.298** respectively. Moreover, it also reveals that there is a significant relationship between the dependent variables (ROA & ROE) and control variables (Leverage & Firm size).

4.3. Multiple Regression Analysis

4.3.1. Model Summary of Return of Assets (ROA) and Explanatory Variables

Table 4 indicates the model summary of return on assets and explanatory variables. It shows R the coefficient of correlation is .661 (66.1%) with return on assets (ROA) by using all the predictors simultaneously. The R2 value is .437 and ad-

justed R² is .412 that shows 41.2% of variation in return on assets (ROA) can be predicted from the explanatory variables, while the remaining 58.8% is influenced by others aspects which are not included in this study.

sets (ROA) is 17.72, which reveals a significant relationship with the explanatory variables.

<Table 3> Correlation Analysis

		ROA	ROE	Board Size	Board Composition	CEO duality	Audit Committee	Leverage	Firm Size
ROA	Pearson Correlation	1							
ROE	Pearson Correlation	.452**	1						
Board Size	Pearson Correlation	.229**	.190	1					
Board Composition	Pearson Correlation	-.143**	-.130	.263**	1				
CEO duality	Pearson Correlation	-.219**	-.186	-.436**	.053	1			
Audit Committee	Pearson Correlation	.376**	.298**	-.282**	.087	.253**	1		
Leverage	Pearson Correlation	-.264**	-.296**	.185**	.116*	.430**	.503**	1	
Firm Size	Pearson Correlation	.140**	.134	-.360**	-.264**	.582**	-.018	.314**	1

** Correlation is significant at the 0.01 level (2-tailed).

* Correlation is significant at the 0.05 level (2-tailed).

<Table 4> Model Summary of Return on Assets (ROA)

Return on Assets (ROA)			
Model	R	R Square	Adjusted R Square
1	.661a	.437	.412

- a. Predictors: Board Size, Board Composition, CEO duality, Audit Committee, Firm Size, Leverage
- b. Dependent Variables: ROA

<Table 6> ANOVA of Return on Assets (ROA)

Return on Assets (ROA)		
Model	F-Statistics	Significance
1	17.72	.000 ^a

- a. Predictors: Board Size, Board Composition, CEO duality, Audit Committee, Firm Size, Leverage
- b. Dependent Variables: ROA

4.3.2. Model Summary of Return on Equity (ROE) and Explanatory Variables

Table 5 shows that R value is .571 (57.1%) with return on equity (ROE) by using all the predictors simultaneously. The R² value is .326 and adjusted R² is .293 that shows 29.3% of variation in return on equity (ROE) due to the explanatory variables, whereas the remaining 70.7% is influenced by other factors which are not included in this study.

<Table 5> Model Summary of Return on Equity (ROE)

Return on Equity (ROE)			
Model	R	R Square	Adjusted R Square
1	.571a	.326	.293

- a. Predictors: Board Size, Board Composition, CEO duality, Audit Committee, Firm Size, Leverage
- b. Dependent Variables: ROE

4.3.4. ANOVA of Return on Equity (ROE) and Explanatory Variables

Table 7 indicates ANOVA of return on equity with all variables used in the study at highly significant level of 0.000, which means that model is best fitted. The F-statistic of return on equity (ROE) is 14.74, which reveals a significant relationship with the explanatory variables.

<Table 7> ANOVA of Return on Equity (ROE)

Return on Equity (ROE)		
Model	F-Statistics	Significance
1	14.74	.000 ^a

- a. Predictors: Board Size, Board Composition, CEO duality, Audit Committee, Firm Size, Leverage
- b. Dependent Variables: ROE

4.3.3. ANOVA of Return on Assets (ROA) and Explanatory Variables

Table 6 indicates ANOVA of return on assets with all variables used in the study at highly significant level of 0.000, which means that model is best fitted. The F-statistic of return on as-

4.3.5. Coefficients of Return on Assets (ROA) and Explanatory Variables

Table 8 reveals that board size and audit committee is statistically significant and positively related to the return on assets (ROA). While, board composition and CEO duality is statistically

significant and negatively related to the return on assets (ROA). Moreover, leverage is statistically significant and negative related to the return on assets (ROA), while the relationship with firm size is positive but statistically insignificant.

<Table 8> Coefficients of Return on Assets (ROA)

Return on Assets (ROA)			
Model	Beta	t	Sig.
(Constant)		4.43	.000
Board Size	.147	1.98	.049
Board Composition	-.083	1.65	.054
CEO duality	-.276	-3.99	.000
Audit Committee	.286	4.19	.000
Leverage	-.189	-2.39	.017
Firm Size	.041	.629	.530

4.3.6. Coefficients of Return on Equity (ROE) and Explanatory Variables

Table 9 indicates that board composition and CEO duality is negatively related to the return on equity (ROE), but their relationship is insignificant. It also indicates that audit committee is statistically significant and positive related with return on equity (ROE). Similarly, it also shows that board size is positively related to the return on equity (ROE), but their relationship is statistically insignificant. Moreover, the control variable leverage is negatively, whereas firm size is positively related to the return on equity (ROE).

<Table 9> Coefficients of Return on Equity (ROE)

Return on Equity (ROE)			
Model	Beta	t	Sig.
(Constant)		1.29	.196
Board Size	.161	.780	.436
Board Composition	-.099	1.89	.090
CEO duality	-.050	.697	.486
Audit Committee	.140	1.97	.050
Leverage	-.318	-3.85	.000
Firm Size	.150	2.17	.030

5. Conclusions

This study investigates the effect of corporate governance practices such as (board size, board composition, CEO duality and audit committee) on firm performance for a sample of 80 firms listed on Karachi Stock Exchange (KSE) Pakistan during 2010-2014. The findings indicate that board size is positively related to the firm performance. This result indicates similarity with the forecast of resource dependence theory, recommending that a board with high levels of association with external environ-

ment can increase a company access to different resources, therefore positively affecting firm performance. Empirical results of (Dwivedi & Jain, 2005; Coles et al., 2008; Ehikioya, 2009) also indicate that board size has positive association with firm performance.

It also reveals that there is negative relationship between board composition and CEO duality with firm performance. The negative association of board composition with firm performance may be because of very low appearance (12.40%) of outside directors setting on Pakistani companies boards that strengthen managers to seize company resources for their personal benefits. The negative association between CEO duality and firm performance is in contradiction to the stewardship theory, recommending that authoritative decision making under leadership of a single individual leads to higher performance. On the other hand, a positive association is similar to the agency theory, recommending that combining both roles decision management and decision control into a single position would weaken board control and negatively affect firm performance.

Further it also indicates a positive and significant relationship between the audit committee and firm performance. This finding indicates that assuming good corporate governance practices that are associated to the effectiveness of audit committee can increase firm performance. Moreover, the study also find negative relationship between leverage and firm performance, whereas a positive association between firm size and performance.

5.1. Limitations

The sample size of the study is small and could not cover the overall industry of Pakistan. Further, this study is limited to the time period of five years which is short. Moreover, it is also limited to the accounting based measures of performance and could not include the market based measures of performance. The future research should be set at increasing the sample size, the corporate governance variables, and the time frame in order to have more correct and valuable results.

5.2. Recommendations

This study examines that corporate governance practices such as (boardsize, board composition, CEO duality and audit committee) has significant affect on firm performance. Therefore, it is recommended that to increase performance, company should improve its governance structure. It is also suggested that to register high performance, companies should understand the improving governance and sustain ability performance is as essential as improving firm performance. The study also recommends that companies should well describe the corporate governance practices and employs them efficiently in order to get the firm long term objectives, make stake holders assurance and produce positive investment flows.

Competing Interests

The authors declare that they have no financial or personal

relationship which may have inappropriately influenced them in writing this article.

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